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Inflation of money is the symptom; inflation of credit is the disease... To obtain credit is to gain possession of purchasing power.

***Credit of the Nations*, J.Laurence Laughlin**
Scribners Sons, New York, 1918

SOFT OR HARD?

At long last, the great global bear market in stocks has arrived with a vengeance. The carnage is already as bad as it was in 1929. Just as then, few understand why. And just as then, the consensus wants to believe that it is a mere correction, even a healthy correction. Nevertheless, the two most important questions are still waiting for an answer. The one concerns the potential magnitude of the decline in stock prices, and the other one concerns the potential repercussions on currencies and economies around the world, primarily, of course, on the dollar and the U.S: economy. For the time being, there still seems to be overwhelming faith in the wisdom of Mr. Greenspan to avoid past policy errors and manage a soft landing. After all, isn't the U.S. economy bursting with strength?

Avoiding past mistakes essentially requires to have correctly identified them in the first place. Today's consensus view in America, for example, pins the responsibility for the Great Depression on the Fed's failure to "print enough money" after the fact, that is, during the early 1930s after the initial crash of the stock market. It is conveniently forgotten and erased from economic history that far more probably the abusive credit and speculative excesses during the boom were the true villain in the piece.

Have today's policymakers and economists learned from history? Our impression, frankly speaking, is that knowledge of economic history and economic theory has never been lower. Although it was to be expected that Wall Street analysts would readily buy the "new era" mantra, it continues to amaze us that virtually the entire economic community has chimed in. While the stock market mania has certainly impaired the objectivity of analysis, it is increasingly apparent that very serious flaws in the understanding of basic economic concepts are at play as well. One result is truly momentous misconceptions about the true underlying health of the U.S. economy and the soundness of its financial system.

The data clearly and strikingly show that the money, credit and debt excesses that the U.S. economy has experienced in the past four years are by far the worst and most reckless in history. They have run into dimensions that simply defy imagination and comprehension. At the same time, the financial system has taken on unprecedented leverage. By the measure of these excesses, the U.S. economy is heading for deep, deep trouble. Yet, Mr. Greenspan rarely utters the word "credit" and never makes reference to money and credit excess.

From what we read, we have to conclude that elementary macroeconomic insights, such as the essence and function of savings, are unknown to most American economists. Nor do they have the vaguest notion of the necessity to put any limit on credit supply. Speaking of precarious imbalances, they focus on nothing but the changes in the consumer price index.

It seems that macroeconomics is a completely forgotten science in America. Microeconomics, in the sense of making money, rules in splendid isolation. In the light of these facts, it appeared timely to dig a bit into the history of economic thought.

Throughout history "Economics" has passed through several major changes in its concerns and in its

"paradigms." With the rise of the American model of "shareholder value maximization" are economics and economic theory in the throes of another "new paradigm revolution"? Is this the next new paradigm, the new super-efficient economy? Or is this model of "radically new corporate governance" just a bogey concept that does more harm than good to long-term economic growth?

MICRO CONTRA MACRO

"Economics" – according to Webster's, the science of production, distribution and consumption of goods and services, or the material welfare of humankind – began with the "*Mercantilists*" of France in the first half of the 17th century. They were the first to see the economy as an entity obeying its own rules and laws. As a system, Mercantilism was macroeconomic, signifying the study of the economy as a whole. It's central concern was to produce the largest possible export surplus and with it the largest possible inflow of gold and silver. Yet, despite its preoccupation with supply, Mercantilism failed to deliver. The more the French government promoted the manufacture for export and the generation of gold and silver inflows, the poorer the country became because too much of the new riches – in particular under Louis XIV – was wasted on waging wars and royal luxury.

The scientific response in France was the "*Physiocrats*." In their program of economic policy as well as their analytical scheme, agriculture held the central position. The Industrial Revolution had hardly begun while a revolution of agrarian techniques gave a novel actuality to agricultural problems. Their system remained as supply-focused as that of the Mercantilists. But with the individual piece of land and its cultivator as the crucial economic unit, they turned also microeconomist. They were the first to develop a theory that did not equate "wealth" solely with "money." The one and only source of value creation in their concept was nature – that is, land – in its economic manifestation.

THREE KEY ISSUES

"Classical economics" – the third revolution in economics, developing since the late 18th century - took both the concern with supply and the focus on microeconomics from the Physiocrats. But it shifted the theory of creating value and prosperity from "nature and land" to "man and capital formation" in the form of physical, productive assets.

The Classics centered their attention on three issues: first, *capital accumulation*; second, *economic equilibrium*; and third, *free markets*. On the macroeconomic level, they focused primarily on savings and capital spending as the key sources of, and also the key limits to, economic growth and productivity advances, while on the microeconomic level they focused primarily on profits as the critical determinant of the necessary investment spending.

The starting point of their reflections was the understanding that only real capital formation in the form of tangible assets is able to generate wealth and economic growth, its first effect on the economy being higher demand and higher employment, and its second and final effect being higher supply, higher productivity and higher living standards. For them, *capital accumulation* was present and future growth.

ESSENTIAL EQUILIBRIUM

But this investment-related *growth theory* had a crucial complement in a distinct *equilibrium theory*. Free markets and the pursuit of private gain will maximize the community's output, as Adam Smith had proclaimed. But it was fully recognized that for market capitalism to work smoothly and efficiently in coordinating the interplay of numerous individual decisions and transactions in the economy and the markets, it required a stable monetary framework. The crucial equilibrium condition was embodied in their credit theory.

It stipulated a necessary balance between credit expansion and available current savings. The role of the

financial system in any economy is to transform savings into investment and to allocate those funds among competing users. Any credit expansion, *uncompensated* by savings, is in essence of inflationary nature, regardless of what is happening to the price indexes. To preserve the equilibrium between the two aggregates is the function of interest rates and the task of monetary policy. What causes the crisis is the credit excess, not a rising price index.

Microeconomics, in contrast, is concerned with the behavior and the strategies of individual firms in the pursuit of optimizing productivity and of adjusting to risks and to changes in technology, business conditions and financial markets. But the classical economists had little or no interest in these questions. Instead they chose to explore the optimal macroeconomic conditions for economic growth, inferring that good macroeconomics inherently assure, through the price mechanism, good microeconomics.

For the Classics, healthy economic growth inherently implied investment-led growth, considering levels of investment as the most important determinant of increased productivity and higher living standards. Government and consumer borrowing in this view were a waste of savings, implicitly diminishing economic growth in the long run. Taking both the necessity and the reality of economic growth for granted, these economists also took ever-rising capital investment for granted. It was their further conviction that free markets and an unfettered price mechanism would regulate current production, both in volume and direction, in optimal pattern. Yet in their view the most important single condition for such balanced growth to materialize was an interest rate level that keeps investment spending within the limits of available savings. Any disturbance of this equilibrium through credit excesses, they warned, would essentially lead to recession or depression by calling forth dangerous disturbances in the price system and hence in the allocation of resources.

FROM KEYNESIANISM...

Classic economics lost its appeal during the Great Depression. Ironically, Austrian theory, could perfectly explain the crisis, but it lost favor with policymakers and economists because it rejected activist government measures. In their view, the disjointed economic system had to go through a painful readjustment process.

Along came John Maynard Keynes, pleading for activist government action to break the economic deadlock. His approach was demand-focused rather than supply-focused. In all earlier economics, demand was regarded as a function of supply, in other words, of production. In his economics, supply is a function of demand and controlled by it, inferring that economic growth depends on the expansion of demand through money and credit creation. Or, rather; production and employment are regulated by monetary influences: money supply, credit, interest rates, and governmental deficits or surpluses. In analysis and associated policy recommendations this was pure macroeconomics.

...TO REAGANOMICS.

But the long-term effect of Keynesian economics was dwindling capital formation and "stagflation," that is, an unusual coexistence of economic stagnation and inflation. America's answer in the 1980s was Reaganomics, a new synonym for supply-side economics, implying that government policies would now primarily aim for increasing the potential supply of goods and services, emphasizing tax reductions and deregulation as the appropriate measures. The most spectacular feature of this new approach was a three-year 30% cut in marginal income tax rates on personal and business income. As advertised, these drastic tax cuts would give such a tremendous boost to work efforts and business investment that supply would rise much faster than demand, lowering inflation, interest rates and budget deficits.

In fact, everything was literally turned on its head. According to the supply-side story, the lower tax rates would accelerate economic growth by boosting savings and investment spending. The reality was the precise opposite: an unprecedented consumer borrowing and spending binge with exploding budget and trade deficits,

while productivity growth remained as lackluster as before. The obvious cause of this productivity fiasco was an investment fiasco.

All through the 1980s, private consumption, propelled by borrowing, soared as a share of GDP. The ugly corollaries of this consumption boom were declining levels of both net saving and net investment. As a share of GDP, the net investment ratio declined to 5%, nearly two percentage points below the postwar average level of 7% through 1982. The main victim was manufacturing investment. Contrary to its claims, "supply-side" Reaganomics did not deliver more capital formation, but less. For several years, net investment in manufacturing was zero.

True, real economic growth had accelerated, while the inflation rate fell from 12.5% in 1980 to 4.6% in 1989. This coincidence was hailed as the great achievement of Reaganomics. But the push toward higher growth had definitely not come from the supply side. There were two distinctive features of the U.S. economy's performance in the 1980s: a meteoric rise in overall indebtedness and a substantial increase in the share of GDP that is consumed, inherently implying capital consumption rather than higher capital formation. Over the decade, total outstanding debts skyrocketed from $4.1 trillion to $12.8 trillion.

There was an alarming message in these numbers that American policymakers and most economists flatly ignored: To generate economic growth, it takes increasingly larger dosages of credit and debt creation. During the three decades since World War II, each dollar in incremental GDP growth required approximately $1.40 of additional debt. At the end of the 1980s, that debt-to-GDP ratio had soared to $2 with a rising trend.

WHAT REVOLUTION?

We come to the latest revolution in economics: ***neo-American-style capitalism with rigorous microeconomics as its foundation.*** While the Classics had aimed at boosting productivity and profits through increased savings and investment spending, this new "Theory of Corporate Efficiency" proclaims the "maximization of shareholder value" as the supreme target and measure of corporate performance, obviously assuming that what is best for the single firm must essentially be best for the economy as a whole. Wasn't that also the quest of the Classics?

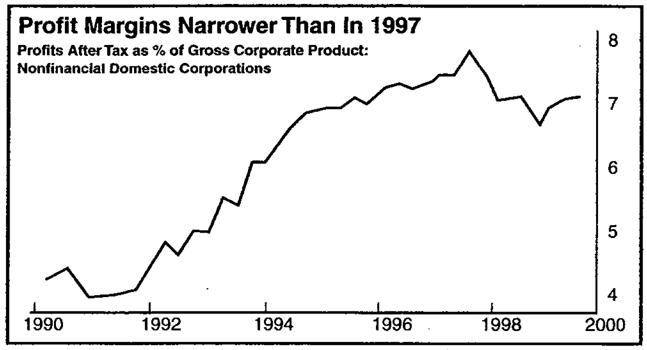
American policymakers and economists love to promise economic miracles by claiming revolutionary changes in their thinking and their policies. In the 1980s, the promised economic miracle was supposed to come from big cuts in tax rates and deregulation. The new miracle is expected to arise from aggressive cost-cutting and corporate "restructuring" in association with the broad and rapid implementation of the new information technologies, all carried out by managers inspired and enlightened by the new corporate imperative that maximizing shareholder value is their primary task and only responsibility.

We have always been highly critical of this concept. In essence, it is the most narrow-minded microeconomics in history. This has its reason in complete blindness to the fact that the postulated microeconomic priorities implicit to the goal of maximizing shareholder value diametrically conflict with the macroeconomic essentials for strong and healthy economic growth.

This assessment brings us back to a point we have repeatedly addressed, and that the old economists called the "*fallacy of composition.*" This little theorem posits the potential discrepancy between positive individual action and negative aggregate effects. The relevant point is: What appears advantageous for a single firm is not necessarily favorable for the economy as a whole. If one firm cuts wages, it is able, ceteris paribus, to raise profits and expand output; but once every firm follow suit, the impact on the economy as a whole is just the opposite: an overall income contraction. The example that is usually referred to in textbooks is a rise in savings during depression.

To grasp the validity of this fallacy in the case of the new American capitalism, just take a look at the list of measures that U.S. corporations favor today in their pursuit of maximizing shareholder value: mergers,

acquisitions, restructuring and downsizing. In the last analysis, these are all different names for cost-cutting. All too obviously, the advocates of these expedients don't have the faintest inkling of the "fallacy of composition" inherent to these predominant strategies. In fact, all these measures supposedly optimising profits on the micro-level are outright profit killers on the macro-level. It is not without reason that the U.S. economy's profit performance in recent years has been less than mediocre, even despite spreading resort to accounting gimmicks to enhance reported earnings.



Source: Levy Institute

As explained, past economic theories were overwhelmingly focused on macroeconomic variables and the implications of their changes. Yet, the crucial role of profits in propelling economic growth was perfectly understood, even by a man like Keynes. To quote him:

> "Unemployment exists because employers have been deprived of profits. The loss of profit may be due to all sorts of causes. But there is no possible means of curing unemployment except by restoring to employers a proper margin of profit. There are two ways of doing this – by increasing the demand for output, which is the expansionist cure, or by decreasing the cost of output, which is the contractionist cure. Both of these try to touch the spot. Which of them is to be preferred?...The advantages to employers of a general reduction of wages are not so great as they look. Each employer sees the advantage to himself, but he overlooks both the consequences of the reduction of incomes of his customers and of the reduction of wages which his competitors will also enjoy."

THE TRUE NEW U.S. PARADIGM

It is a peculiar feature of the new American management imperative, "maximize shareholder value," that it appears to justify almost any practice used to that end. As stock prices and price-earnings ratios soared, euphoric expectations of investors are exerting intense pressure on executives to deliver the double-digit earnings growth of the past years forever. For sure, this pressure has worked magnificently as far as stock prices are concerned. Patently, it kindled unprecedented zeal among American corporate management to comply with the new imperative. More importantly, however, it has ushered in a profound change in corporate strategies to raise profits not only as much as possible, but also as fast as possible. In the new climate, the focus turned single-mindedly on cutting costs.

As a matter of fact, controlling and reducing costs has always been one of corporate management's most prominent tasks. But the decisive point about it was that in the past it largely took place through productivity and capacity-enhancing investment spending into new and better equipment, expanding simultaneously the supply of resources. In the same vein, this investment spending used to be the major source of growth on the demand side. Micro- and macroeconomics perfectly converged.

Perceptions about the best economic model have changed over time. For quite a while, the German model, then the Japanese model, enjoyed the world's admiration. Today, the lean and flexible American model is deemed triumphant, as the U.S. economy has been enjoying record-high growth with record-low unemployment and yet low inflation - enough, it seems, to justify sky-high stock prices, which in turn have delivered the most fantastic wealth-creation in history. In this light, the neo-American model has proved its superiority. Has it?

The ready explanation of this "miracle" is that two things, above all, have altered the U.S. economy's parameters: first, the wide and rapid application of the new information technologies; and second, a jump in corporate efficiency, elicited by the market-imposed imperative that management's only task is to maximize

shareholder value.

INSTANT GRATIFICATION IS TRUMPS

Cost-cutting *per se* has, effectively, been elevated to a single-minded obsession among corporate managers and investors. Not only that. The second novel twist, as already mentioned, concerns the specific choice and pattern of cost-reductions. The favored approaches are those that are believed to deliver the higher profits in the shortest possible time. Instant gratification is trumps. It is important to realize this because it has had far-reaching consequences for corporate strategies.

There are good and bad ways to increase profits. The traditional good way is organic expansion through productivity and capacity enhancing new investment. But for impatient investors and corporate managers this seems too time-consuming and rather fraught with risks. Looking for quick fixes, American managers fell in love with acquisitions, mergers, restructuring and downsizing. What is so particular about these expedients? In short, they seem to promise fastest gratification because the cherished cost-cutting takes place in an *existing* plant.

Doing and marketing such deals is the surest way to make a splash on the financial pages, which also tends to help stock prices. Mere announcements of such plans have tended to do wonders in this respect. That, indeed, is the U.S. economy's true "new paradigm" feature. Certainly, it seems to be the safest, the fastest and also the most riskless way to improve profits. But is it really? Our following answer is a categorical no.

WINDFALLS OR PITFALLS?

In a rational world, you would think that somebody would later check whether and to what extent the promised great efficiency gains from the famous "synergies" have actually materialized. Strikingly, nobody seems to care about the final results. Once a deal is done, interest in the combined company vanishes. Yet the myth of the great efficiency gains, inherent to mergers and acquisitions, survives. For his 1997 book The Synergy Trap, Mark Sirower analyzed 168 deals made between 1979 and 1990 and concluded that two-thirds of them destroyed shareholder value, largely because of unfulfilled expectations from synergies. As an aside, the Daimler-Chrysler stock is now around 60 after being at 103 euros at its height, and Vodafone, after swallowing Mannesmann, has quickly gone from £ 4 to 2.6 so far. Nobody is interested in the truth. Perception, make-believe and short-term effects on stock prices are everything in this economic model.

To be sure, this merger and acquisition mania in the past few years has magnificently served its purpose to maximize shareholder value, at least in the short run. The clinching question, though, are the implications of these cost-cutting strategies for long-term economic growth and higher living standards, not just for stockholders but for the whole community, as it used to be true under the "old" capitalism. Mergers, acquisitions, restructuring, downsizing and cost-cutting in general are definitely no substitutes for organic growth. For real economic miracles one has to look to capital formation, embodied in new investment in plant and equipment, as the most important single factor in determining the rate of productivity growth and true wealth creation.

But aren't the expected big efficiency gains from information technology finally showing up in the productivity statistics? Real GDP growth rates of 4% and higher are not only thinkable; they have become normal. Yes, but the GDP numbers in the last few years have benefited by well over one percentage point from changes in the way government statisticians measure consumer prices and computer output – kicking up estimates of economic growth and productivity gains in the process.

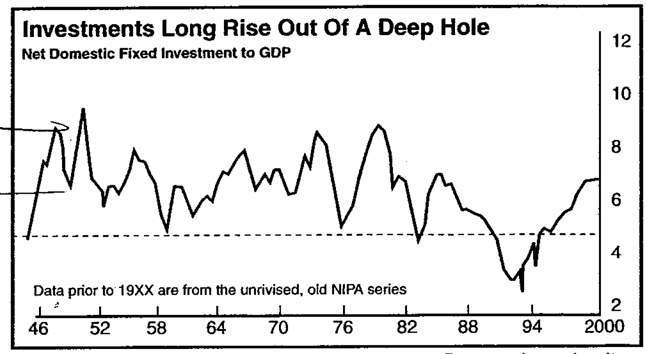
WHAT INVESTMENT BOOM?

On the surface, the U.S. capital spending cycle appears to be in rarefied territory. In real terms, business fixed investment rose to 13.7% of real GDP in 1999, up 2.9 percentage points from 10.8% in 1995. Spending

on equipment and software skyrocketed over this period by 60%. As a percentage of GDP, this investment component increased from 8% to 11%, by far its highest ever ratio.

On closer inspection, however, the capital spending boom is not exactly what these aggregate numbers suggest. First of all, the figures in "chained" dollars employed for the calculation of real GDP growth are immensely flattered by the use of the "hedonic" price deflator for computers. Consider that for the three-year period, 1996-99, this measure has catapulted $26.9 billion actually spent by businesses in current dollars on computers into $150 billion in fictive chained dollars. By the way, only the United States practices this statistical procedure.

A second snag is a growing difference between *gross* and *net* investment. What critically matters for long-term economic growth is the *net* increase in the capital stock after depreciation, and that is growing rather moderately. This is because of a pronounced shift in new investment spending away from long-lived "structures" towards short-lived equipment, inferring a rising ratio of capital depreciation. While net investment has strongly recovered, it remains below the long-term average, which was never on the high side by international comparison.



Source: Levy Institute

Assessing these figures, it has to be taken into account that net investment spending in the 1980s had virtually collapsed. The gains in the 1990s therefore reflect a rise out of a deep hole. While it has sharply recovered, it remains less than average from a long-term perspective.

THE GRAT IRONY

It further turns out that the increases in capital spending have been narrowly concentrated in information technologies, accounting over the three-year period, 1996-99, for 70% of total non-residential investment, measured in chained dollars. Outside of the high tech sector, there is more weakness than strength. A very remarkable and certainly ominous feature of the trend in U.S. capital spending is the persistent and pronounced sluggishness in two components. The one is the anemic rate of growth in industrial equipment, up a paltry 9% for the same three-year period, just 3% per annum. And the other one are "structures." up 10% over the same period. As a share of total investment spending, they accounted for 4% each. All these figures relate to gross investments.

Earlier, we said that for economic miracles one has to look to capital formation as the most important single factor in determining the rate of productivity growth and of true wealth creation. Well, capital formation has been the fiasco of the so-called "supply-side" Reaganomics. Far from strengthening the supply side, it delivered an unexampled consumer borrowing and spending binge instead that ravaged capital formation.

The great irony about today's U.S. "new paradigm" economy is that the negative trends of the 1980s have not just continued, they have dramatically worsened, except in government finances. True, investment spending has recovered from the lows of the 1980s, but literally everything else has gone to unprecedented excess, plainly attributable to a credit expansion that is completely out of control. Consider that over the three-year period, 1996-99, the debt-to-GDP ratio, measuring debt growth ($ 6,000 billion) in relation to GDP growth ($1,400 billion), was a little over 4:1, more than double the rate of the late 1980s, signalling a rapidly rising dependence of the economy and the financial markets on ever-more rampant credit and debt creation.

Just consider the most worrisome, rapidly worsening imbalances: the slump in personal saving toward almost zero; the biggest private sector deficit in history; new records in consumer and corporate borrowing; an explosive rise in the current-account deficit; a surge in foreign indebtedness to 20% of GDP and rising; a ratio

of debt to net worth in nonfinancial corporations double that in 1980. To speak of an economic miracle in America, you have to close your eyes to all these imbalances and dislocations.

THE VILLAIN: SHAREHOLDER VALUE

Two numbers in particular have fuelled the prevailing perception of the U.S. economy's stellar health and strength. They are the monthly employment figures and the quarterly real GDP growth numbers, surprising continuously on the high side. We suspect that in general little more is known. No less importantly, it is also readily believed that this extraordinary economic performance inherently reflects the U.S. economy's superiority in dynamism and health, as Wall Street continues to trumpet.

We have always stressed one point: Assessing the U.S. economic and financial boom since the 1995 and looking for its chief propellant, forget the palaver about the mythical "new paradigm." The unmistakable answer lies in two aggregates: credit and debt growth, on the one hand; a sharp rise of private consumption as a share of GDP on the other. Last year, it was 84%, as against a long-run average of about 66%. As to credit and debt flows, we can only repeat what we have said so many times: the American reality of the last four years is the wildest and most reckless credit and debt binge that the world has ever seen.

To give an idea: During the first five years of the 1990s, total broad money supply (M3) expanded $273 billion, or about $55 billion annually. During the second half of the decade, its overall increase was about $2,000 billion, or about $ 400 billion each year. That was eight times as fast as in the preceding period. Total credit growth almost doubled between the two periods from a little over $4 trillion in the first half of the 1990s, and almost $8 trillion in the second half. What's more, there has been rapid, progressive acceleration in the credit and debt growth. How can anybody overlook this unprecedented debt orgy?

Reaganomics, as already mentioned, proved a gross delusion. Instead of strengthening the U.S. economy's supply side by higher capital accumulation, it weakened it by boosting consumer spending at the expense of investment spending. But the development in the last few years is even worse from a long-term perspective. While it may be debatable, why Reaganomics, with its emphasis on cutting tax rates, went so terribly wrong, the reasons for the failure of the "new economics" of the 1990s are self-evident. The obvious villain is precisely the "shareholder value" charade.

On closer look, this narrow emphasis on maximization of shareholder value as the primary measure of corporate success is a silly concept simply because there exist too many ways, other than improving efficiency, to achieve this result. True, it has unleashed unforeseen energies among corporate managers to effectively lift profits and shares prices. Conspicuously, however, these energies have been heavily directed toward devices that used to rank as undesirable financial and accounting gimmicks, prominently massive stock buybacks. Implicitly, these gimmicks seem to be necessary to hide the mediocre development of true operational profits.

However, that's not all. The overriding negative implication of this manic search for quick gains in stock price is that it intrinsically undercuts capacity- and productivity-enhancing capital accumulation for the future. The compelling proof is there to see. Who wants to see it, however?

THINK MACRO, NOT MICRO

In the preceding brief review of the economic theories of the past, we noted that all of them centered primarily on the macroeconomic requirements of economic growth. We went through this history of economic thought in order to put the new Wall Street capitalism in perspective. It definitely is microeconomics in its essence. Its topic is the well-being of the firm and its owners. Yet its advocates claim - just like the Classics did - that the pursuit of private gain also maximizes overall output and prosperity.

But the thinking of the Classics started with a sound macroeconomic perspective about the crucial

importance of capital spending both for economic growth and general corporate profitability. Wall Street thinking begins and ends with stock prices and a narrow microeconomic perspective. Take the often-cited view that the stock market gains should be viewed as savings. Many years ago, as a matter of fact, Mr. Greenspan shocked us with a remark of this kind.

Savings, as conceived in economic theory, represent unspent current income. Their essence is the release of resources for the production of housing, plant and equipment. These physical facts are basic. Clearly, capital gains in the stock market are a completely different matter. To the extent that consumers spend such gains, the resources available for capital formation are evidently decreased, implying dissaving.

We come to the decisive fallacy in the American "restructuring" model. It concerns the general corporate passion for cost-cutting as a means to enhance profits. Employee costs are, clearly, a major influence on a firm's profits. Accordingly, it appears self-evident that when firms throughout the economy reduce their wage bill, their aggregate profits must improve. But there is a logical snag with this conclusion.

For the business sector as a whole, cutting employee compensation reduces their revenue in lockstep. Lesser corporate pay translates into lesser wage income, which in turn translates into lesser consumer spending and thereby, ultimately, into lesser business revenue, frustrating the rise in profits, in line with the ill-famed "fallacy of composition." Another self-evident inference from this recognition is that the participants in the merger and acquisition sweepstake in pursuit of micro synergy effects are chasing a macro phantom. Putting it bluntly: the "restructuring" model, with its single-minded emphasis on corporate cost-cutting as a source of profit generation, doesn't make any sense. In the aggregate, it is self-defeating.

CAPITAL FORMATION AS PROFIT SOURCE

But what, then, does make sense from a macro perspective? In seeking to find out the source or sources of *aggregate* profits, our interest is in the flows of funds that determine total profits available for businesses. Actually, it can be put into a simple equation: All business expenses reduce profits; all business revenues increase profits. Aggregate profits, in short, are the excess of aggregate business revenue over aggregate business costs.

All this sounds quite simplistic, but it leads straight to a conclusion of great importance. Among many different sorts of expenditures of the business sector, there is one specific kind that is not immediately expensed, and that is net capital spending. Instead, these expenditures are in the balance sheets of the buyers capitalized. Owing to this treatment, net fixed investment from a macro perspective is typically the largest and most important profit source in a capitalist economy. No expense is incurred until the first depreciation charge is recorded. But to the sellers of the newly produced plant or machine, the transaction is a sale that creates revenue.

The same considerations have led us to suspect that the new information technologies will in general prove a profit flop. A comparison with the industrial technologies is instructive. To put these into practice and effect their widespread employment in the economies required huge and time-consuming capital accumulation among producers and users of these technologies. Though it may seem paradoxical, the heavy capital formation implicated was just the decisive condition that made these technologies the great wealth and profit creator.

What about the new information technologies? Can a techno-boom rescue profitability? The short answer is no, and a main reason is that both the production and the use of these technologies simply involve too little capital formation. We have followed with great interest the reports about Internet retailers. Their great advantage has been seen in the low capital investments required to start such a business, compared to Old Economy businesses. But the more upstarts are attracted to the web, the higher the marketing costs needed to attract customers. And above all, there is a crucial difference between the two kinds of costs involved. Expenditures on the creation of tangible wealth are capitalized. Expenditures on marketing are current costs that reduce profits.

True, these innovations are breathtaking, but we should not confuse this fact with economic value and, in particular, not with their ability to create profit and wealth.

MR. GREENSPAN: OUT OF TIME AND OPTIONS

Back to the question "soft or hard landing" for the U.S. economy. We see a host of reasons that speak for a hard landing, but not one that might give reasonable hope for a soft landing. Our only unsettled question is how hard will the landing be. The primary reason for this assumption is the phenomenality of the credit excesses and imbalances that have accumulated in the economy. Meanwhile, though, Mr. Greenspan has gotten himself into a trap.

It was always assumed that the Fed would stand ready to ease aggressively should the market suffer a sharp decline. But he has gambled that possibility away by his prolonged reluctance to move decisively against the twin bubbles in U.S. equity and real estate. Meanwhile, the booming asset prices have been propelling the economy into overheating. Inflation has, at long last, accelerated to an uncomfortable level. Personal savings have virtually vanished, and the trade gap has ballooned to $400 billion a year. As a result, Mr. Greenspan has run out of time and out of options because these conditions don't allow him any easing, whatever may happen to the stock market. To the contrary, he is forced to raise interest rates. It is often asked whether the Fed's rate hikes will work. Well, the Fed has no choice. They are compelled to proceed until it does work, and mind you, the longer it takes, the higher interest rates have to be pushed up, the worse the aftermath. Ask the Bank of Japan.

Still, Mr. Greenspan's greatest hazard certainly looms in the currency markets. The dollar's strength in defiance of the soaring trade deficit so far has surprised us. Actually, this is in perfect accordance with what happened in the 1980s. Then, too, the dollar skyrocketed virtually doubling against the DM, from DM 1.70 to a peak of DM 3.47 in early 1985, despite an exploding trade deficit. There were even the very same scornful comparisons between the ailing economies of Europe and the super-healthy and dynamic U.S. economy. For Europe, the popular, derisive catchword was "euro-sclerosis," while U.S. economic policy basked in the glorification of "supply-side Reaganomics."

While the stock market took off in leaps, the whole world looked on with admiration, readily ascribing the recovering economy and the booming market to the new policies. In truth, as clearly evidenced by the official statistics, it was runaway monetary expansion and an unusual consumer borrowing and spending binge that propelled the economy from the demand side. What goes up must come down. The dollar's deep and long slide that was to carry it to a low of DM 1.35, started in earnest when the U.S. economy began to slow and the Fed began to ease.

This past experience with the dollar offers a good tip for predicting the coming dollar crisis: follow the trail of debt excesses. The decisive causes of every single, serious economic and currency crisis are credit and debt excesses. Apparently, one cannot repeat it often enough: the U.S. credit and debt excesses of the past few years are beyond past experience in history, essentially leaving behind a horribly vulnerable economy and financial system. This tells us to expect a very hard landing of the economy with a steep, steep fall of the dollar. When you compare the present with the dollar's slide in the 1980s, remember one key difference. Today's U.S. economy is a bubble economy. 1980's was not.

As explicated, there are tremendous misconceptions about the causes of the U.S. economy's strength. Exactly the same is true about the dollar's strength. It is explained, just as in the1980s, with arguments that put the soaring trade deficit into the rosiest light. Normally, rising trade deficits have the same ugly cause: domestic demand growth outpacing domestic output growth because of excessive monetary looseness. But this explanation hardly fits the glorious image of a "new paradigm" economy.

Instead the most-cited cause of the deficit is that the U.S. economy's stellar performance has made Wall

Street the great magnet for global capital. As the thinking goes, global investors are stampeding into U.S. stocks. European corporations in particular, are rushing in with mergers and acquisitions to participate in America's economic miracle. In this view, the trade deficit has nothing to do with credit excesses in the United States. Rather, it is due to healthy, long-term capital inflows, and hence the dollar is not vulnerable to an abrupt "hot money" exodus. By the way, this was already the standard explanation for the soaring dollar in the 1980s.

To assess the dollar' vulnerability, look at the facts. The U.S. current-account deficit increased to $338.9 billion in 1999 from $220.6 billion in 1998, and $143.5 in 1997. That is, the deficit has doubled within the two years. It is already well above $400 billion. By far the important causes were soaring merchandize imports, as against virtually stagnating exports. By the way, the deficit with Western Europe increased to $52.9 billion from $34.9 billion. The deficit with Japan, for comparison, rose to $74.9 billion from $65.3 billion.

The key to dollar strength or weakness lies, of course, in the capital account. In fact, the United States even had huge capital outflows of $325.1 billion on top of the current-account deficit. Together, trade deficit and capital outflows in 1999 required a capital inflow of $750.8 billion. Which specific components within this immense total inflow have, in the last analysis, determined the dollar's extraordinary strength against the euro is essentially very difficult, if not impossible, to decide. Strictly speaking, what we are witnessing is really euro weakness since the dollar is in trade-weighted terms slightly down with a sharp slide against the yen.

The biggest single item among U.S. capital inflows, showing also the biggest increase, were foreign bond purchases, amounting last year to $325.9 billion, up from $218 billion. The bulk of these purchases were in U.S. corporate and U.S. government agency bonds offering higher yields than Treasuries. Considering the movements of the currencies, yen up, euro down, it has to be assumed that the buying has largely come from Europe. In other words, the dollar's super strength against the euro has been conditioned and triggered chiefly by aggressive American borrowing, not by foreign investing. With given interest rate differentials, the U.S. borrowing binge has simply spilled over abroad. This too, by the way, is in striking conformity with what boosted the dollar in the earlier 1980. Then the key was the U.S. banking system, which heavily borrowed in the euro market.

UNDER LOOMING DOLLAR CRASH

In the 1980s, the dollar grossly overshot, and so again, this time against the euro.

While interest differentials have played a role in both cases, they are never the key factor. Historically, weak currencies have high interest rates, and strong currencies have low interest rates. German and Japanese interest rates have generally been well below U.S. interest rates, yet the two currencies, being considered perennially strong, kept rising against the dollar, being considered perennially weak.

The euro's biggest problem is that the European economy, its policymakers and its central bank have quickly succeeded in acquiring a thoroughly bad image. Conversely, the American economy, its policymakers and in particular Mr. Greenspan enjoy global, unbridled admiration. It has become the deeply ingrained perception in the markets that the U.S. economy and its currency are perennially strong, and consequently, the dollar has remained strong, even though the trade deficit is approaching astronomic numbers.

There is nothing new about overshooting currencies, and herd behavior in all markets is the rule rather than the exception. Even more absurd than the dollar's spurt, by the way, was the eruption of the yen. Buying the bull story that Corporate Japan is aggressively restructuring, American investors poured about $46 billion into Japanese stocks last year, while heavily selling European stocks. Yet, while we have great misgivings about the rationality of the markets, we think that repeated, stupid remarks by European policymakers and central bankers have substantially contributed to euro weakness. With or without intent, they gave the impression of wanting a weak euro for the stimulation of exports.

Still, our expectations of a coming steep fall of the dollar against the euro were never conditioned by great expectations about the European economy. Our decisive consideration behind this assumption has always been the glaring misconception of what lies behind the U.S. economy's superior growth performance: not a "new paradigm" economy but the greatest credit and debt excesses that the world has seen. In short, the worst ever "bubble economy."

By the way, the economy doesn't need a mass flight from the dollar to send it plunging. Given the monstrous current-account deficit, just a decline in new net capital inflows is enough to trigger it. If you think it over, you realize that a potential dollar disaster is looming, far worse than one in the late 1980s. It may appear remarkable how well the dollar has weathered the wreckage in the stock market so far. But deeply entrenched perceptions have a habit of changing painstakingly slowly.

Everybody hopes that a slowing U.S. economy will soon relieve the pressure on the Fed to hike interest rates further. However, any slowing will hammer profits, and just consider the increasing difficulty of paying people with stock options in a bear market. And how will the wizard Greenspan cope with a weakening economy in the face of a plunging dollar?

CONCLUSIONS:

All considerations about the prospects for the world economy, currencies and financial markets have to start with one key query: Is the U.S. economy a new paradigm or a bubble economy? Manifestly, both the economy and the financial markets have been propelled by the greatest and most reckless credit and debt bubble in history.

We adhere to the Austrian economics dictum that the pain and dislocations to be suffered with the later, inevitable economic and financial reversal are rather proportionate to the scale of the excesses in the preceding boom. By this logic, incomprehensible excesses forewarn of incomprehensible predicament.

By far the greatest dangers do not loom in the U.S. inflation rate but in the mammoth current-account deficit and the currency markets. A plunging dollar is prone to cause systemic risk.

Just a short note to apologize. Last month we included a letter with your issue about Bill Bonner's Daily Reckoning. The Daily Reckoning is a free e-letter Bill sends out to readers interested in a contrarian take on the stock market--plus a lot of other commentary on life, politics, and the history of the 20th century. Unfortunately, the link we sent you may have been broken. If it was, our apologies. We have fixed the problem and encourage you to visit www.dailyreckoning.com/declare/7097 and sign up today.

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